Effective Date: January 9, 1998

COORDINATED ISSUE
PETROLEUM INDUSTRY
REPLACEMENT OF UNDERGROUND STORAGE TANKS
AT RETAIL GASOLINE STATIONS

ISSUES:

1. Whether the costs incurred to: (a) remove and replace underground storage tanks; (b) clean up soil contaminated by releases from the tanks; and (c) to install monitoring systems, wells or other equipment associated with groundwater cleanup are capital expenditures under sections 263(a) and 263A of the Internal Revenue Code or are currently deductible expenses under section 162.

2 Whether the costs incurred to: (a) remove underground storage tanks; (b) clean up soil contaminated by releases from the tanks; and (c) to install monitoring systems, wells or other equipment associated with groundwater cleanup are capital expenditures under sections 263(a) and 263A or are currently deductible expenses under section 162, where the tanks will <u>not</u> be replaced with new tanks.

FACTS:

Companies in the petroleum industry market gasoline through company-owned retail locations and through branded independent marketers. The independent marketers may either own or lease the property. The petroleum companies and independent marketers will collectively be referred to as "the taxpayers".

The taxpayers are corporations or partnerships on the accrual method of accounting. The retail locations generally consist of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline or a convenience store used to market nonpetroleum items, a canopy covering the gasoline pumps and sometimes the building, and in some cases a car wash facility. The gasoline pumps are connected to underground storage tanks (USTs) by pipes buried under the paved area. The pumps also are usually connected to a monitoring unit in the building that allows the sales clerk to monitor the gasoline sales.

In 1988, the Environmental Protection Agency (EPA) issued regulations addressing (1) technical standards for design, construction, installation, and operation of UST systems, (2) requirements that the states must meet in order to administer the federal

UST regulatory program, and (3) financial responsibility requirements to ensure that UST owners are able to take corrective action in the event of a release from a tank system. In complying with the EPA regulations, taxpayers have incurred substantial costs in removing and replacing leaking USTs and in cleaning up the related contamination.

The basic steps involved in replacing underground storage tanks typically include removing the old tanks and installing the new tanks with leak detection system. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, lifting the old tanks out of the hole, and properly cleaning and disposing of the old tanks. Installation of the new tanks typically includes placement of a liner or barrier in the excavated hole, placement of the new tanks, installation of one or more leak detection systems, installation of an overfill system, connection of the tank to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. If the tanks or pipes have leaked, a number of options are available to the taxpayer to evaluate and clean up the contamination. For example, the taxpayer may install monitoring wells to evaluate the contamination, excavate and dispose of the contaminated soil, and install a water filtration and treatment system.

Taxpayers typically claim deductions for the costs incurred to remediate the contamination resulting from leaking USTs. In addition, taxpayers may claim deductions for the removal, cleaning and disposal costs of old tanks and, in some cases, the installation and/or acquisition costs of the new tanks.

LAW:

The deductibility of the costs incurred in connection with the removal and/or replacement of assets, such as USTs, is determined under sections 162 and 263 of the Code. In general, section 162 provides a deduction for ordinary and necessary business expenses. Section 1.162-4 of the regulations allows taxpayers to deduct the costs of incidental repairs that neither materially add to the value of property or appreciably prolong its life, but keep it in an ordinarily efficient operating condition. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, are capitalized and depreciated.

Section 263 of the Code generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Under section 263(a)(2), no deduction is allowed for amounts expended in restoring property or in making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion.

Section 1.263(a)-l(b) of the regulations provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong useful life of property owned by the taxpayer, such as plant and equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) of the regulations provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A of the Code provides that taxpayers must capitalize the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer. Section 263A(g)(1) provides that, for purposes of section 263A, the term "produce" includes construct, build, install, manufacture, develop, or improve.

Through provisions such as section 162(a), 263(a), and related sections, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., INDOPCO, Inc. v. Commissioner, 503 U..S. 79, 84 (1992); Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). Moreover, as the Supreme Court specifically recognized, the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. Welch v. Helvering, 290 U.S. 111, 114 (1993); Deputy v. du Pont, 308 U.S. 488, 496 (1940) ; see also INDOPCO, Inc.v. Commissioner, 503 U.S. at 87.

DISCUSSION:

Removal and Replacement of Tank

The cost of removing the old tank, the cost of the new replacement tank and the cost of installing the new replacement tank must be capitalized under 263(a). These costs are capital expenditures, rather than deductible repairs, because the new tank is a replacement of the entire depreciable asset rather than a mere part or component. The replacement does more than merely arrest deterioration and prolong life -- it is the acquisition of a new asset. Thus, a replacement consisting of a new tank is beyond the scope of the repair exception to capitalization provided by section 1.162-4.

The costs incurred to remove any concrete or paving material, remove soil[1] to gain access to the old tank, remove the old tank, and install the new tank are capital expenditures. The costs of excavating the soil surrounding the old tank are part of the costs of installing the replacement tank. These costs are necessary to install the new tank, which is a capital expenditure, and therefore are properly considered part of the capitalized cost of the new tank.

Generally, in cases where a taxpayer incurs costs to remove one item in order to replace it with another, the courts have analyzed these costs together as part of one improvement. For example, in Phillips & Easton Supply Co. v. Commissioner, 20 T.C. 455 (1953), the taxpayer, a vendor for industrial supplies and equipment, replaced the three-inch cement floor in its building with a five-inch reinforced concrete floor. The court held that the expenses of removing the old floor and installing the new floor were capital expenditures because the old floor had worn out and the new floor was a replacement and an improvement. The court noted that the replacement was a substantial, structural work, and the new floor made the building more valuable for use in the taxpayer's business because it accommodated the storing, handling, and moving of heavy equipment and inventories. See also Mennuto v. Commissioner, 56 T.C. 910 (1971); Stewart Supply Co., Inc. v. Commissioner, 22 T.C.M. (CCH) 246 (1963).

The old UST and the new replacement UST are each separate depreciable assets, rather than components of a larger asset, such as a building, as in the cases cited above. However, despite their separate nature, the tanks function as part of a larger structure, the gasoline pump system. This functional integration of the tanks into the gasoline pump system necessitates that the replacement tank be situated in the same place as the old tank. Because the new UST must be located in the same place (the hole created by excavation to remove the old UST) as the old UST, it is necessary to remove the old UST in order to install the replacement UST. Therefore, as to those sites where the replacement USTs are installed in the same location as the old USTs,

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[1]The costs incurred by a taxpayer to clean up the soil or groundwater contaminated by released from its USTs during the course of its business operations are deductible as business expenses undr section 162. Because these costs merely restore the soil and groundwater to their approximate conditions before they were contaminated by releases from the taxpayer's USTs, they do not result in improvements that increase the value of the taxpayer's property. See Rev. Rul. 94-38, 1994-1 C.B. 35. For example, such deductible costs would include the costs to remove the contaminated soil to appropriate disposal facilities, and backfill the excavated areas with clean soil. These costs are deductible whether the taxpayer owns or leases the retail facility. The tax treatment of these costs is not affected by the removal and replacement of the tank because these costs affect a different asset (i.e., the soil, rather than the tank). Thus, these costs cannot be capitalized as part of an overall plan of rehabilitation for the tank or the retail facility. Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987).

the costs of removing the old UST are part of the costs of installing the new UST and must be capitalized into the basis of the newly installed UST.

However, the costs of cleaning and disposing of the old tanks are deductible as business expenses under section 162. Sections 167 and 168 authorize a taxpayer to recover the basis of a depreciable asset through depreciation or cost recovery deductions. These sections do not provide an independent deduction for the expenses related to an asset's retirement.[2] To the extent that a taxpayer incurs costs to retire an asset, these costs must have an independent ground for deduction under section 162.

Taxpayers retire and dispose of USTs in the ordinary course of their business. The costs of cleaning and disposing of the tank for purposes of retirement are not incident to creation of a capital asset and do not themselves create or enhance a capital asset or create significant long-term benefits. Therefore, the costs of cleaning and disposing of the old USTs constitute business expenses deductible inder section 162.

The tax treatment of these costs is not affected by the removal and replacement of the tank because these costs affect a different asset (i.e., the soil/real property, rather than the tank). Thus, these costs cannot be capitalized as part of an overall plan of rehabilitation for the tank or the retail facility. Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987).

Groundwater treatment facilities, such as wells, pipes, and pumps to extract, treat, and monitor groundwater, and other types of monitoring equipment have a useful life substantially beyond the taxable year in which they are constructed and/or installed. Therefore, the costs of their construction and installation are capital expenditures under sections 263(a) and 1.263(a)-2(a). See Rev. Rul. 94-38, supra. Moreover, because the construction or installation of these, facilities constitutes production within the meaning of section 263A(g)(1), the direct costs and a proper share of allocable indirect costs of constructing and installing these facilities must be capitalized under section 263A. The capitalized costs of the groundwater treatment facilities and other monitoring equipment may be depreciated pursuant to section 168.

Removal of Tank Without Replacement

As discussed above, the costs of cleaning and disposing of the old UST are deductible under section 162. A taxpayer may choose to remove the UST, but not replace the

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[2] For example, section 1.167(a)-11(d)(3)(x) of the regulations directs that costs of dismantling, demolishing, or removing ADR property in the process of a retirement are currently deductible, but the deduction itself arises under section 165 rather than section 167.

tank(s). Under such circumstances, because a new UST is not installed, the costs of removing the old UST are part of its deductible retirement costs, rather than part of the costs of installing a new UST.

The tax treatment of the cleanup costs is not affected by the taxpayer's failure to replace the UST. For example, a taxpayer may choose to remove but not replace the tank at a site where it no longer conducts business operations. As discussed above, costs incurred by a taxpayer to remediate soil and groundwater contaminated by releases from its tanks during the course of its business operations are deductible as business expenses under section 162 because they do not produce permanent improvements to the taxpayer's property. See Rev. Rul. 94-38, supra.

Similarly, the tax treatment of the costs of installing monitoring systems, wells, or other types of equipment to remediate the contaminated area is not affected by the removal and/or replacement of the tanks. As discussed above, the direct costs and a proper share of allocable indirect costs of constructing and installing these facilities must be capitalized under section 263A, regardless of whether the tanks are replaced.

CONCLUSIONS:

1. (a) Costs incurred to remove and replace underground storage tanks are capital expenditures under section 263(a) and 263A. These costs must be capitalized to the basis of the new tank.

   (b) Costs incurred to clean up the soil are deductible as business expenses under section 162, where such costs are incurred by the taxpayer who contaminated the property.

   (c) Costs of installing monitoring systems, wells or other equipment associated with the remediation and cleanup of the contaminated area, including direct and allocable indirect costs under section 263A, must be capitalized to the basis of the equipment. These costs may be recovered over the appropriate period determined under section 168.

2. (a) Costs incurred to remove underground storage tanks and remediate the soil, in cases where the tanks will not be replaced, are deductible under section 162, where the costs are incurred by the same taxpayer who contaminated the property. This does not apply in cases where the costs are incurred to adapt the property to a new or different use.

   (b) Costs of installing monitoring systems, wells or other capital assets associated with the remediation and cleanup of the contaminated areas, including direct and allocable indirect costs under section 263A, must be capitalized, regardless of whether the USTs are replaced.